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No. 81-523

In The

Supreme Court of the United States

October Term, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal From the Court of Appeal
of the State of California
for the First Appellate District

BRIEF FOR

SONY CORPORATION
KEIDANREN (JAPAN FEDERATION OF ECONOMIC ORGANIZATIONS)
KANKEIREN (KANSAI ECONOMIC FEDERATION)
ELECTRONIC INDUSTRIES ASSOCIATION OF JAPAN
HORIBA INTERNATIONAL CORPORATION
KYOTO CERAMIC CO., LTD.
MATSUSHITA ELECTRIC INDUSTRIAL CO., LTD.
NIPPON ELECTRIC CO., LTD.

AS AMICI CURIAE IN SUPPORT OF APPELLANT

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STATEMENT OF INTEREST

This Brief is submitted with the written consent of the parties on file with the Clerk of this Court.

The *amici* constitute various Japanese parent corporations which have United States subsidiaries operating in the United States, as well as three Japanese trade associations, Keidanren

(Japan Federation of Economic Organizations)[1], Kankeiren (Kansai Economic Federation)[2], and Electronic Industries Association of Japan.[3]

The interest of the trade associations in this proceeding stems from the fact that some of the members thereof constitute foreign parent corporations with United States subsidiaries operating in the United States. Similarly, the interest of each of the *amici* companies stems from the fact that each of them is a foreign parent corporation with a United States subsidiary operating within the United States.

Some of the *amici* are currently challenging the propriety of the combined report/formula apportionment method, applied on a worldwide basis, at the administrative level in one or more states, and the others expect to challenge the method in due course.

Under the combined report/formula apportionment method (simplistically referred to by some commentators as the "unitary approach," "unitary apportionment approach," or by similar terms), foreign parent corporations are being forced by

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[1] Keidanren (Japan Federation of Economic Organizations) is a private, non-profit organization representing all branches of economic activities in Japan. As of December 1981, the organization consists of 916 members, of which 110 are associations, such as trade associations and regional economic organizations, and the balance are leading Japanese enterprises and foreign companies operating in Japan. The purpose of Keidanren is to maintain close contact with various economic sectors in Japan and abroad in an effort not only to find practical solutions to economic problems but also to contribute toward the sound development of the economies of Japan and the world.

[2] Kankeiren (Kansai Economic Federation), established on October 1, 1948, has a membership of over 500 corporations, over 100 organizations, as well as a number of individuals of the Kansai area. Its objective is to contribute to the sound development of the Japanese economy by submitting the opinions and recommendations of the Kansai business community to the relevant authorities.

[3] Electronic Industries Association of Japan is a trade association with approximately 600 members, of which approximately 70 constitute foreign parent corporations with United States subsidiaries operating in the United States.

various states to, in effect, file a consolidated return with all of their worldwide subsidiaries (euphemistically called a "combined report" of a unitary group). The total worldwide income of the consolidated group is then allocated to a specific state under the so-called "three-factor formula" apportionment method, i.e., on the basis of the relative amounts of their property, payroll, and sales in the taxing state, as compared to the total worldwide property, payroll, and sales of the consolidated group.

The *amici* are entirely different from Appellant in that they are foreign corporations, whereas the Appellant is a United States parent corporation.

The problem of imposing the combined report/formula apportionment method is entirely different when a foreign parent corporation is involved than it is when a United States parent corporation is involved. Foreign nations are not concerned with whether the United States imposes the combined report/formula apportionment method upon an affiliated group with a United States parent corporation. However, foreign nations are intensely concerned when a state imposes the combined report/formula apportionment method upon an affiliated group with a *foreign parent* corporation.

The combined report/formula apportionment method does not conform to international principles of taxation, and, indeed, such method is completely antithetical to international principles of taxation. Under the tenets laid down by this Court in *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), any method of taxation affecting foreign commerce which does not conform to international principles of taxation violates the Foreign Commerce Clause because this Nation must speak with "one voice," in matters of "foreign intercourse and trade," and this Nation, as well as many other nations of the world, has adopted the arm's length method [i.e., measuring income as if all relationships were between independent parties] as the bedrock of international tax relationships.

The *amici*, as foreign parent corporations, do not presume herein to advise this Court as to the proper method of taxing income earned within the United States. They are only concerned that the measurement of that income earned within the United States be determined under the internationally accepted arm's length method. Once the United States income is so determined, the taxation of that income becomes a matter of internal concern within the United States. This concept of limiting the application of formula apportionment to the territorial boundaries of the United States (*i.e.*, the "water's edge"), and using the arm's length method to separate foreign income from United States income, is commonly referred to as the "water's edge" rule.

The concern of the *amici* is to alert this Court to the fact that the principles which this Court may enunciate in this case with respect to United States parent corporations, by reason of the sovereign right of the United States to tax its own corporate citizens, have entirely different Constitutional implications under the Foreign Commerce Clause if such principles are extended to affiliated groups owned by foreign parent corporations (*i.e.*, " foreign multinational enterprises"). It is imperative, in the case of foreign multinational enterprises, that this Nation speak with "one voice," and that this Court make it clear that the combined report/formula apportionment method cannot be imposed upon foreign income of such foreign multinational enterprises.

SUMMARY OF ARGUMENT

This Court, in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), laid down two principles, over and above those applicable to interstate commerce questions, against which state taxes must be tested under the Foreign Commerce Clause of the United States Constitution (Article I, Section 8, Clause 3). One is that the tax cannot prevent the Federal government from "speaking with one voice" with respect to international relations. The second is that the tax, "notwithstanding apportionment," must not create a substantial risk of multiple taxation.

Combined reporting/formula apportionment, when applied to foreign income of a foreign multinational enterprise, violates both these principles. Tax harmonization is of paramount importance in international commercial relations. Thus, it is of paramount importance that the Federal government speak with "one voice" in this area, and it has so spoken. Indeed, most of the non-communist major nations in the world have also so spoken, as have various world organizations. Every nation has emphatically endorsed the arm's length method rather than formula apportionment as the touchstone of international tax harmonization.

If this Court were to embrace the combined report/formula apportionment method as applicable to foreign income of foreign multinational enterprises, the Constitutional requirement that the Federal government speak with "one voice" would be emasculated.

The parties in the instant case will no doubt extensively debate whether arm's length or combined report/formula apportionment method more accurately measures worldwide income, and we, too, will touch upon that question herein. In the case of the foreign income of a foreign multinational enterprise, however, that question need never be reached. In

that arena, both Constitutionally (under the Foreign Commerce Clause) and pragmatically, the threshold critical inquiry is to determine if there is some common touchstone of taxation which has been agreed upon by the competing nations.

Within the United States, the formula apportionment method makes sense on the theory that, among other things, there is comity and uniformity as between the states, and the United States courts are in a position to remedy any injustice. At the international level, however, this is not true. The nations of the world have agreed upon an entirely different touchstone of taxation; namely, the arm's length method. Therefore, the arm's length method must, both equitably and under the Foreign Commerce Clause, be the method endorsed by this Court as to foreign income of foreign multinational enterprises.

Formula apportionment has been rejected by the Federal government, and (so far as is known) by all nations of the world which impose an income tax. Formula apportionment (and certainly combined reporting) is aberrational, asymmetrical, and repugnant to every country, including, at the Federal level of taxation, the United States.

The combined report/formula apportionment method prevents the Federal government from speaking with "one voice" and this, alone, renders the method invalid as applied to foreign income of foreign multinational enterprises. However, in addition, the combined report/formula apportionment method violates the second principle set forth in *Japan Line, Ltd.* with respect to foreign commerce in that it creates the risk of multiple taxation, and even more than that, multiple taxation in fact.

The combined report/formula apportionment method originated as a judicially created concept which was borrowed from property tax cases as an expedient, albeit rough, method of dividing profits within the various states of the United States. It has been developed and nurtured in the context of operations within the United States where such things as productivity, investment costs, payroll costs, risk factors, and taxing patterns

are reasonably comparable and where the currency is the same. Fundamental to the rationale of the method is the assumption that all states within the United States are homogeneous in terms of economic and taxing conditions. This basic assumption is not applicable on a worldwide basis and the method becomes inequitable and distortive when extended to the nonhomogeneous world.

The inequity of extending combined report/formula apportionment abroad is exacerbated by the fact that this method results in a heavier tax burden on affiliates of foreign corporations operating within the United States than on affiliates of United States corporations operating solely in the United States. Within the United States, when one state utilizes formula apportionment, correlative adjustments should be made by other states, and, if not made, the courts can relieve any inequity. In the international arena, no such correlative adjustment occurs since all foreign nations utilize the arm's length method.

Because combined reporting/formula apportionment violates internationally agreed principles of taxation, and because it is asymmetrical and distortive, the attempted imposition of combined report/formula apportionment by states such as California has engendered a number of formal protests by foreign countries, and this raises the concern, expressed by this Court in *Japan Line, Ltd.*, that an asymmetrical state tax may lead to potential retaliation by disadvantaged foreign nations.

ARGUMENT

I.

THE RATIONALE OF *JAPAN LINE, LTD.* PRECLUDES THE IMPOSITION OF THE COMBINED REPORT/FORMULA APPORTIONMENT METHOD ON FOREIGN INCOME OF FOREIGN MULTINATIONAL ENTERPRISES

In *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) this Court determined that when a state seeks to tax instrumentalities of foreign commerce, two additional requirements, beyond those applicable to interstate commerce, must be met under the Foreign Commerce Clause of the Federal Constitution. First, the state tax must not "impair federal uniformity in an area where federal uniformity is essential" and, in that regard, "[f]oreign commerce is preeminently a matter of national concern."[4] In short, the Federal government must speak " 'with one voice when regulating commercial relations with foreign governments.' "[5]

Among the reasons why this Court indicated that the Federal government must speak with one voice is that even "[i]f the State imposes an apportioned tax, international disputes over reconciling apportionment formula may arise."[6] If a state tax creates an "asymmetry in the international tax structure" then foreign nations "may retaliate."[7]

Second, the state tax must not create "a substantial risk of international multiple taxation."[8]

As stated by this Court, if the state tax "contravenes either of these precepts it is unconstitutional under the Commerce Clause."[9]

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[4] 441 U.S. 434, at p. 448.
[5] *Ibid.*, at p. 451.
[6] *Ibid.*, at p. 450.
[7] *Ibid.*, at p. 450.
[8] *Ibid.*, at p. 451.
[9] *Ibid.*, at p. 451.

Both of the prescribed requirements would be violated if this Court were to embrace the combined report/formula apportionment method with respect to non-United States operations of foreign multinational enterprises. " 'In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power,' "[10] and this Court has stressed "the need for uniformity in treating with other nations."[11]

Japan Line, Ltd. involved a property tax, rather than an income tax, but the constitutional limitations which apply to state taxing powers do not differentiate among different kinds of taxes, and it is obvious from the *Japan Line, Ltd.* opinion that this Court did not intend to confine that decision to property taxes. This Court's discussion of the governing principles did not distinguish between various kinds of taxes.

In *Japan Line, Ltd.*, this Court distinguished *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), and *Washington Revenue Department v. Stevedoring Association*, 435 U.S. 734 (1978), as involving interstate commerce rather than foreign commerce.[12] *Complete Auto Transit* involved a privilege tax measured by gross sales or gross income, and *Washington Revenue Department* involved an occupation privilege tax measured by gross income. This Court also cited *Evco v. Jones*, 409 U.S. 91 (1972), involving a gross receipts tax, and *J. D. Adams Manufacturing Co. v. Storen*, 304 U.S. 307 (1938), involving a state gross income tax,[13] and quoted from *Board of Trustees v. United States*, 289 U.S. 48 (1933), which was an import duty case.[14]

It is clear that this Court in *Japan Line, Ltd.* meant to enunciate principles applicable to all types of taxes. The gravamen of an invalid tax is its burden on commerce and not

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[10] 441 U.S. 434, at p. 448.
[11] *Ibid.*, at p. 448.
[12] *Ibid.*, at p. 445.
[13] *Ibid.*, at p. 446.
[14] *Ibid.*, at p. 448.

what it is called. Taxes which result in multiple burdens on interstate or foreign commerce are invalid regardless of the kind of tax involved.[15] Most importantly, however, the nature of the tax is obviously irrelevant to the necessity that the Federal government speak with "one voice."

II.

TAXATION OF FOREIGN COMMERCE IS GOVERNED BY AN INTERNATIONAL NETWORK OF TREATIES WHICH SPEAK WITH "ONE VOICE" IN FAVOR OF THE ARM'S LENGTH METHOD

Multinational trade must be governed by international rules of taxation, not peculiar taxing concepts of nations, and certainly not of political subdivisions of nations. It is imperative that the United States, as well as the other nations, speak with "one voice" in agreeing upon such international rules. Most of the non-communist major countries of the world, including, of course, the United States, have entered into an extensive network of treaties covering the avoidance of double taxation of income. The United States has entered into income tax conventions with twenty-nine countries, and treaties with some

[15] Although this Court declined to apply the *Japan Line* rationale in *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425 (1980), which involved an income tax, the *Mobil* situation was correctly analyzed by this Court as involving only issues of interstate commerce, not foreign commerce, since *Mobil* conceded that the dividend income in question could be taxed by the State of New York. Moreover, *Mobil* involved only the issue of multiple taxation, and not the issue that the Nation must speak with "one voice."

Similarly, this Court's decision in *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 U.S. 271 (1924), which upheld apportionment (not combined reporting) as to a foreign parent corporation operating directly within the United States, involved, insofar as the Foreign Commerce Clause was involved, only the limited issue of whether the tax constituted a direct tax on foreign commerce, and not the issue that the Nation must speak with "one voice." Moreover, international economic, trade, and tax relationships today can hardly be compared to those which existed in 1918 (the fiscal year in issue), over 60 years ago.

twelve additional countries have been signed but are not yet in effect.[16] The touchstone of taxation under all of these treaties is the arm's length method, *viz.*, the "water's edge" rule.[17]

The proper allocation of income is a major matter in the negotiation and implementation of treaties between nations. International conformity on this issue is critical "if there is to be order and rationality in the tax relationships among nations."[18] "[T]he rules of national tax systems and their interaction with the systems of other countries," are "[a]mong the major impediments to freer capital and technology flows."[19]

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[16] 1 CCH Tax Treaties, pp. 17-19.

[17] Staff Policy Report of The Advisory Commission on Intergovernmental Relations, published as a separate report entitled "State Taxation of Multinational and Multistate Corporations" (9/4/81). For the convenience of this Court, selected extracts of that report which contain more extensive discussions of material referred to in this Brief are included in the Appendix hereto, pp. 14-17.

The Advisory Commission on Intergovernmental Relations is the permanent commission established by Congress in 1959 to monitor intergovernmental relations and to make recommendations for change. Members include federal, state and local elected and appointed officials and private citizens.

See also Articles 7 and 9 of both the Organization of Economic Cooperation and Development Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital (1977) and the United States Treasury Department's Model Income Tax Treaty of May 17, 1977. See, fns. 22, 23.

[18] Surrey, "Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions," 10 Law and Policy in International Business, 409, at p. 409 (1978) (The International Journal of Georgetown University Law Center). Professor Surrey is a learned tax expert, a Professor of Law, Harvard Law School, former Assistant of Tax Policy, U.S. Treasury Department (1961-69), and Special Advisor to the Rapporteur, United Nations Group of Experts on Tax Treaties Between Developed and Developing Countries.

[19] Statement of Assistant Secretary of Treasury, Lawrence N. Woodworth, before the Senate Committee on Foreign Relations, *Hearings on Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines*, July 19 and 20, 1977, 95th Congress, First Session, Washington, D.C., U.S. Government Printing Office, 1977, p. 28.

"Tax treaties" embodying the arm's length method "represent a highly developed area of international cooperation," and "[f]ew fields come to mind in which international groups have worked so consistently for so long."[20] The stakes in tax harmonization involve more than a mere "desire for orderliness in international tax matters." Unless there is such harmonization, "double taxation of income . . . [will result] in a loss of international investment and income flows."[21]

Various world organizations have repudiated formula apportionment for international use. The arm's length method, *viz.*, the "water's edge" rule, is embodied in both The Organization for Economic Co-operation and Development ("OECD") Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital (1977)[22] and the United States Treasury Department's Model Income Tax Treaty of May 17, 1977.[23] The United Nations Group of Experts on Tax Treaties Between Developed and Developing Countries repudiated formula apportionment as recently as 1978,[24] as did The Organization for Economic Co-operation and Development ("OECD") in 1979.[25]

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[20] Statement of H. David Rosenbloom, International Tax Counsel, Department of the Treasury, before the Subcommittee on Oversight, House Committee on Ways and Means, *Hearings on Income Tax Treaties*, April 29, 1980, 96th Congress, 2nd Session, Washington, D.C., U.S. Government Printing Office, 1980, p. 61.

[21] *Ibid.*, fn. 17, at p. 6.

[22] OECD, Report of the OECD Committee on Fiscal Affairs "Model Double Taxation, Convention on Income and Capital" (1977), published as a separate publication by the OECD. Reprinted at 1 CCH Tax Treaties, § 151.

[23] 1 CCH Tax Treaties, § 153.

[24] Seventh Report, Report of the Group of Experts on Tax Treaties Between Developed and Developing Countries on the Work of its Seventh Meeting, United Nations, Department of Economic and Social Affairs, "Tax Treaties Between Developed and Developing Countries" (1978), published by the United Nations as a separate report. For the convenience of this Court, selected extracts of that report which contain more extensive discussions of material referred to in this Brief are included in the Appendix hereto, p. 21.

[25] Organization for Economic Co-operation and Development, Report of OECD Committee on Fiscal Affairs "Transfer Pricing in Multinational Enterprises" (1979). The Organization for Economic Co-operation and

(Footnotes continued on following page)

In September, 1981, the Staff of the Advisory Commission of Intergovernmental Relations ("ACIR") recommended in a special report that Federal legislation be enacted which would embody the "water's edge" rule as to foreign parent corporations and formula apportionment as to United States parent corporations.[26] This recommendation of the "water's edge" rule by the ACIR Staff as to a foreign parent is the rule that the *amici* herein contend is required by the Foreign Commerce Clause of the United States Constitution.

The conflict between a state's use of combined reporting/formula apportionment and the arm's length, "water's edge" rule utilized by the Federal government and all other nations has been recognized as being of serious proportions in that "the application of a state's unitary system to foreign operations disrupts implementation of the nation's policy of harmonizing, through our network of bilateral tax treaties, our country's tax system with the tax systems of our treaty partners . . . [and is] a substantial irritant in international tax and trade policy."[27]

It is obvious, therefore, that the combined report/formula apportionment method, if imposed on foreign commerce of foreign multinational enterprises, impairs Federal uniformity where "[f]ederal uniformity is essential,"[28] and, accordingly, violates the tenet requiring that the Federal government speak with "one voice" in such matters.

(Footnotes continued from previous page)

Development (OECD) was set up under a convention signed in Paris on December 14, 1960, which provides that the OECD shall promote policies designed to, *inter alia*, contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with the international obligations. The members of the OECD are Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. For the convenience of this Court, selected extracts of that report which contain more extensive discussions of material referred to in this Brief are included in the Appendix hereto, pp. 18-20.

[26] *Ibid*, fn. 17.

[27] *Ibid.*, fn. 17, at p. 11.

[28] 441 U.S. 434, at p. 448.

III.

THIS NATION MUST SPEAK WITH "ONE VOICE" IN TAXING FOREIGN MULTINATIONAL ENTERPRISES TO AVOID STRAINING FOREIGN RELATIONS AND HAMPERING FOREIGN INVESTMENT, AND TO AVOID ANY POTENTIAL RISK OF RETALIATORY TAXATION

The reaction of foreign nations to any proposed imposition of combined report/formula apportionment with respect to foreign operations of foreign parent corporations has been vehemently adverse. Formal letters of protest have been lodged with the United States government by Belgium, Canada, France, Italy, and the United Kingdom, and the nine governments of the European Economic Community, the Japanese government has included the issue in its agenda of grievances in recent trade talks between Japan and the United States, and resolutions condemning such method have been recently adopted by several foreign trade associations.[29]

There also is little doubt but that the attempted imposition of combined reporting/formula apportionment has hampered and increasingly will hamper foreign investments in those states which are attempting to impose the method, and potentially within the entire United States. Reports indicate that investments in California by foreign multinationals have been postponed or abandoned, or have been made in states which do not attempt to impose such a method.[30] The attempted imposition of such a method has also been properly criticized as "unfair," and as a "quick-fix search for new revenues today" which will have to be paid for "in lost growth tomorrow."[31]

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[29] *Ibid.*, fn. 17, at pp. 11-12. Copies of the letters of protest filed by the governments of Canada, France, and the United Kingdom, and by the European Economic Community, and a recent resolution by the Council on Unitary Taxation Issues of Kansai Area, Japan, a Japanese trade association, are included in the Appendix hereto, pp. 1-13, 24-27.

[30] McGraw-Hill, Business Week, 11/2/81, at pp. 131-132. For the convenience of this Court, selected extracts from that publication which contain more extensive discussions of the material referred to in this Brief are included in the Appendix hereto, pp. 22-23.

[31] *Ibid.*, at p. 156.

This Court can imagine the outrage which those in the United States would feel if local jurisdictions of a foreign country, such as provinces, cantons, cities, or the like, were to impose income taxes on subsidiaries of United States corporations doing business in that country on the combined report/formula apportionment basis. The parent United States corporation would rightfully be incensed at demands by local jurisdictions that the entire affiliated group throughout the world file a combined report in that locality and provide records and information about the entire world affairs of the affiliated group, and translate the income and expense of the entire worldwide group into some form acceptable to the locality.

Is it surprising, therefore, that foreign parent corporations are incensed at the actions of those states within the United States which attempt to impose such burdens upon the foreign parent corporation and other corporations within their worldwide affiliated group which have no contact with, nor income from, either that locality or the United States as a whole?

The fact that combined reporting/formula apportionment is so fundamentally violative of international principles of taxation, and is so asymmetrical and distortive in nature, highlights the concern expressed by this Court in *Japan Line, Ltd.*, that such attacks can cause "foreign nations disadvantaged by the levy . . . [to] retaliate against American-owned instrumentalities present in their jurisdictions."[32] In that event, "the nation as a whole would suffer."[33]

A number of foreign countries are so incensed at the inequity and inappropriateness of combined reporting/formula apportionment as applied to foreign multinational enterprises that "[t]hese countries could, therefore, conclude that some appropriate response is required to demonstrate their concern,"[34] which could be "some form of retaliation."[35]

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[32] *Ibid.*, fn. 4, at p. 450.

[33] *Ibid.*

[34] *Ibid.*, fn. 17, at p. 16.

[35] *Ibid.*

Ironically, the United States in 1934 established a precedent for retaliatory taxation when France subjected United States corporations to what was deemed by the United States to be inequitable taxation, and although the dispute with France was ultimately settled by treaty, the retaliatory provision enacted by the United States remains a part of the Internal Revenue Code.[36]

Thus, it is patently apparent that the Federal government must speak with "one voice" in taxing foreign income of foreign multinational enterprises, and individual states cannot be permitted to interfere in this area which has been Constitutionally mandated under the Foreign Commerce Clause as within the exclusive province of the Federal government.[37]

IV.

THE COMBINED REPORT/FORMULA APPORTIONMENT METHOD APPLIED TO FOREIGN INCOME RESULTS IN ACTUAL DOUBLE TAXATION OF FOREIGN MULTINATIONAL ENTERPRISES AND THUS IS CONSTITUTIONALLY PROHIBITED

The combined report/formula apportionment method creates more than the risk of multiple taxation on multinational enterprises; it produces multiple taxation in fact. Thus, the method cannot withstand the constitutional scrutiny required by *Japan Line, Ltd.* Foreign parent companies, and each of their subsidiaries which operate in a foreign country, are taxed by the foreign country or countries in which the particular corporation

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[36] *Ibid.*, at p. 17. See IRC § 891, and testimony of John S. Nolan before the Senate Finance Committee, *Hearings on State Taxation of Interstate Commerce and Worldwide Corporate Income*, June 24, 1980, 96th Congress, 2nd Session, Washington, D.C., U.S. Government Printing Office, 1980, p. 21.

[37] It is, of course, well settled that the Foreign Commerce Clause, even though "Congress has not pre-empted the field by affirmative regulation," affords "protection from state legislation inimical to the national commerce." 441 U.S. 434, at p. 454.

operates on the uniform, internationally accepted, arm's length principle. The income being earned by each of these corporations in each of the countries in which it operates is taxed in full and without any apportionment. To the extent that any state within the United States applies the combined report/formula apportionment method on a worldwide basis, it attributes to that state a certain portion, as determined by the formula, of income which already has been taxed 100% by a foreign country (and at the foreign local level in countries such as Japan, Germany, Switzerland and Canada, which impose taxes at both the national and local level).[38] Since a foreign country has already taxed 100% of that income, the imposition by a state of a tax on a portion of that same income subjects that income to double taxation.

The problem of multiple taxation is exacerbated by the fact that foreign parent corporations with affiliates operating within the United States are required, under the combined report/formula apportionment method, to endure a heavier tax burden on their affiliates' operations within the United States than are affiliates of United States parent corporations operating solely within the United States, since, within the United States, there is some uniformity in the allocation of income as between the states, but this would not be true as to income earned in foreign jurisdictions.

To the extent that affiliates of United States parent corporations operate solely within the United States and one state utilizes the formula apportionment method, correlative adjustments should be made by other states in the allocation of income to those other states under the formula apportionment method. To the extent the states are not uniform in applying the formula method, the United States courts have the power to relieve any inequity.[39]

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[38] In some instances, however, as is true with respect to Appellee, Caterpillar Tractor Co., the formula can attribute less income to a state than the arm's length method.

[39] See, *e.g.*, *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931), *Norfolk & Western R. Co. v. State Tax Comm.*, 390 U.S. 317 (1968).

On the other hand, to the extent that income of a foreign parent corporation and/or its foreign affiliates is, through the combined report/formula apportionment method, deemed to have been earned in a state, no correlative adjustment in the allocation of income is possible in the foreign country, since all foreign countries utilize international arm's length principles. Further, no power exists in the United States courts to remedy this obvious injustice.[40]

V.

THE COMBINED REPORT AND FORMULA APPORTIONMENT METHODS WERE PECULIARLY DEVELOPED FOR PURPOSES OF STATE TAXATION OF UNITED STATES OPERATIONS, AND CANNOT EQUITABLY OR CONSTITUTIONALLY BE EXTENDED ABROAD.

Since combined reporting/formula apportionment, when applied to foreign income of foreign multinational enterprises, demonstratively interferes with the Federal government's need to speak with "one voice," this Court does not need to reach the question of whether combined reporting/formula apportionment is, on the merits, appropriate in such circumstances.[41] However, even on the merits, combined report/formula apportionment comes up wanting.

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[40] In *Japan Line, Ltd.*, this Court observed that under these circumstances "multiple taxation inevitably results." 441 U.S. 434, at p. 447. Methods under foreign law for according double tax relief are geared to the arm's length method and thus normally can be expected to accord either no relief, or only limited relief, from double taxation resulting from formula apportionment.

[41] In any event, the formula apportionment method, "when applied to an enterprise touching two or more countries requires some international authority or arrangement to be operable, and hence at least on a short-range horizon does not seem feasible." Surrey, *op. cit.*, fn. 18, at p. 416.

The combined report/formula apportionment method involves two separate concepts of state taxation which are peculiar to state taxation within the United States. The requirement of a combined report, i.e., the required filing of a combined return by a related group of corporations, is required by only a few states, such as California (and, now, Illinois). Formula apportionment, on the other hand, is used in one form or another with respect to United States operations by virtually all states imposing an income tax, although there are great variations in the manner in which the method is actually applied.

The formula apportionment method originated as a judicially created concept which was borrowed from the property tax cases as an expedient, albeit rough, method of dividing the total profits of an enterprise among the various states in which the enterprise operates.[42] It was developed and has been nurtured in the context of operations within the United States where such things as productivity, investment costs, payroll costs, risk factors, and taxing patterns are reasonably homogeneous, and where the currency is the same. Theoretically, if all states were to apply the concept uniformly (which they do not) and if the tax rates of all states were approximately equal (which they are not), there would be complete and simple harmonization under the formula apportionment method (and even under the combined report method) in that a taxpayer operating solely within the United States would be taxed only once on its income at the state level (and only once at the Federal level). A taxpayer would then be content, since it would be immaterial to the taxpayer how the respective states in which it operated divided up one single state tax burden. Accordingly, the crucial impetus in the development of the

[42] See, *e.g.*, *Adams Exp. Co. v. Ohio State Auditor*, 166 U.S. 185 (1897), *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Butler Bros. v. McColgan*, 315 U.S. 501 (1941).

formula apportionment method within the United States has been the quest for uniformity and comity among the states, rather than mathematical precision.[43]

Formula apportionment purports to accurately measure income, but, in fact, it mechanically divides overall profits of an enterprise on the basis of deemed economic activity in a taxing jurisdiction without regard to the realities of the marketplace. The arm's length method, on the other hand, attempts to track the actualities of the marketplace, where profits (or losses) do not conform to this simplistic formula apportionment method.[44] Formula apportionment conclusively presumes that profits (or losses) flow uniformly from property, payroll, and sales. Although taxpayers have the right to demonstrate that the results of the formula method are inequitable, the burdens imposed upon a taxpayer attempting to demonstrate the arbitrariness of the formula method are almost insurmountable. In truth, however, the formula method is every bit as imperfect as (and sometimes more imperfect than) the arm's length method. The primary virtue of the formula method is its perceived simplicity of administration rather than the commonly expressed rationalization that it more precisely measures income than the arm's length method.

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[43] This was early recognized by Professor T. S. Adams of Yale, one of the early pioneers on the subject, who declared in 1917 to the National Tax Association:

> "What is most needed is a uniform rule. Just what rule shall be selected is less important than the general adoption of the same rule by competing jurisdications."

1917 Nat. Tax Ass'n. Proceedings 185, at 194. A Committee of the National Tax Association, echoing Dr. Adams' views, put the matter thus in 1922:

> "All methods of apportionment of trading profits are arbitrary . . . [T]here is no one right rule of apportionment, . . . [T]he only right rule . . . is a rule on which the several states can and will get together as a matter of comity."

"Report of Committee on the Apportionment Between States of Taxes on Mercantile and Manufacturing Business," 1922 Nat. Tax Ass'n. Proceedings 198, at 201-02.

[44] Surrey, *op. cit.*, fn. 18, at p. 415.

Fundamental to the rationale of the formula apportionment method is the assumption that all of the states have at least roughly comparable economic and taxing conditions. On a worldwide basis, however, this rationale becomes inapplicable.

There are wide ranges in wage rates and productivity of labor in different areas of the world; substantial differences exist in costs and productivity of plant, equipment, and other property; risk factors and rates of return are different, currencies are different, and conversion rates fluctuate. Moreover, substantial practical administrative difficulties exist in trying to accommodate books and records and different accounting practices in foreign countries to American standards, and taxing patterns differ in other countries, with the result, since many states give neither a credit nor a deduction for foreign income taxes, that the income base against which the formula method is applied is not comparable, and the product of the formula method is accordingly greatly distorted.

Thus, the formula apportionment method, which was developed for application to activities within the reasonably homogeneous United States, becomes inequitable and distortive when applied to the nonhomogeneous world. World conditions are simply far more diverse than conditions as between the states of the United States, and, accordingly, combined report/formula apportionment method is inappropriate for worldwide application.

CONCLUSION

Whatever decision this Court may make with respect to the Appellant herein, it is respectfully submitted that this Court should make it clear that the arm's length method is the internationally accepted rule of law with respect to the *foreign income* of *foreign multinational enterprises;* that this Nation must speak with "one voice" in international commercial relations; and that any attempt by a state to impose the combined report/formula apportionment method on such *foreign income* is therefore in clear violation of the Foreign Commerce Clause of the United States Constitution.

Respectfully submitted,

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Dated: July 30, 1982

APPENDIX

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Canada

September 26, 1980

The Honorable
Allan J. MacEachen,
Deputy Prime Minister and
Minister of Finance of Canada,

Sir:

I have the honor to acknowledge receipt of your note of September 26, 1980, which reads as follows:

"I have the honour to refer to the Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed today, and to confirm certain understandings reached between the two Governments with respect to the Convention.

1. In French, the term "societe" also means a "corporation" within the meaning of Canadian law.

2. The competent authorities of each of the Contracting States shall review the procedures and requirements for an organization of the other Contracting States to establish its status as a religious, scientific, literary, educational or charitable organization entitled to exemption under paragraph 1 of Article XXI (Exempt Organizations), or as an eligible recipient of the charitable contributions or gifts referred to in paragraphs 5 and 6 of Article XXI, with a view to avoiding duplicate application by such organizations to the administering agencies of both Contracting States. If a Contracting State determines that the other Contracting State maintains procedures to determine such status and rules for qualification that are compatible with such procedures and rules of the first-mentioned Contracting State, it is contemplated that such first-mentioned Contracting State shall accept the certification of the administering agency of the other Contracting State as to such status for the purpose of making the necessary determinations under paragraphs 1, 5 and 6 of Article XXI.

It is further agreed that the term "family," as used in paragraphs 5 and 6 of Article XXI, means an individual's brothers and sisters (whether by whole or half-blood, or by adoption), spouse, ancestors, lineal descendants and adopted descendants.

3. It is the position of Canada that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to United States offices or subsidiaries of Canadian companies results in inequitable taxation and imposes excessive administrative burdens on Canadian companies doing business in those states. Under that method the profit of a Canadian company on its United States business is not determined on the basis of arm's-length relations but is derived from a formula taking account of the income of the Canadian company and its world-wide subsidiaries as well as the assets, payroll and sales of all such companies. For a Canadian multinational company with many subsidiaries in different countries to have to submit its books and records for all of these companies to a state of the United States imposes a costly burden. It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by a treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. Canada continues to be concerned about this issue as it affects Canadian multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with Canada on this subject.

4. I have the honour to propose to you the present Note and your reply thereto shall constitute an agreement between our two Governments on these matters.

I confirm these understandings on behalf of the Government of the United States of America. These understandings constitute an agreement between our two Governments on this matter, which will enter into force on the date of entry into force of the Convention between the Government of the United States of America and the Government of Canada with Respect to Taxes on Income and on Capital which was signed today.

Accept, Sir, the renewed assurances of my highest consideration.

(Signed by: G. William Miller
Secretary of the Treasury)

France

His Excellency
Francois de Laboulaye
Ambassador of France

2. It is the position of the Government of France that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to the United States offices or subsidiaries of French corporations, results in inequitable taxation and imposes excessive administrative burdens on French corporations doing business in those states. Under that method the profit of a French company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the French company and its worldwide subsidiaries as well as the assets, payroll, and sales of all such companies.

For a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for all of these corporations to a United States state, in English, imposes a costly burden.

It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with France on this subject.

3. The Explanatory Note issued by the French and American Governments will cease to have effect for periods to which this Protocol applies. With respect to the taxation of American residents in France under this Convention, the two governments have agreed that:

a. Contributions to pension, profit-sharing, and other retirement plans which qualify under the United States Internal Revenue Code will not be considered income to an employee and will be deductible from the income of a self-employed individual, to the extent that such contributions are required by the terms of the plan and are comparable to similar French arrangements;

b. Payments received by the beneficiary in respect of the plans referred to in (a) will be included in income for French tax purposes, to the extent not exempt under subparagraph (2)(a)(ii)(c) of Article 23 of the Convention, at the time when, and to the extent that, such payments are considered gross income under the Internal Revenue Code;

c. Benefits received by reason of exercise of stock options will be considered compensation for French tax purposes at the time and to the extent the exercise of the option or disposition of stock gives rise to ordinary income for United States tax purposes;

d. United States state and local income taxes imposed in respect of income from personal services and any other business income (except income which is exempt from French tax under the Convention) shall be allowed as business expenses;

e. The Frence Government will attempt to reach a reasonable solution with American residents of France regarding the taxation of employer-provided benefits which are not considered income by the United States;

f. In applying the provisions of French law referred to by paragraph 2(c) of Article 23, the French Government clarified how the exemption with progression provision applies. The tax due is that proportion of the tax on total income which taxable (non-exempt) income bears to total (exempt plus taxable) income. For example, if a taxpayer has a total income of $20,000 of which by reason of this

Convention only $12,000 is taxable by France, the French tax will be 60 percent ($^{12,000}/_{20,000}$) of the tax computed on a total income of $20,000.

If this is in accord with your understanding, I would appreciate a confirmation from you to this effect.

Accept, Excellency, the renewed assurances of my highest consideration.

George S. Vest
Assistant Secretary
for European Affairs

United Kingdom

British Embassy
Washington, D.C. June 23, 1980

Hon. Harry F. Byrd, Jr.
Russell Senate Office Building
U.S. Senate, Washington, D.C.

My Dear Senator Byrd: In the context of the hearing of your Taxation Sub-Committee tomorrow on S. 983 and S. 1688, may I bring to your attention the views of my Government on the application of unitary taxation to the U.S. subsidiaries of British companies, set out in a note (copy attached) communicated to the Administration on March 25, 1980.

J. Anson, Minister, Economics

(Press release issued by the British Embassy
Information Department)

U.K./U.S. DOUBLE TAXATION CONVENTION

The ratification by the Exchange of Instruments of the UK/US Double Taxation Convention took place in Washington on 25 March 1980.

The Convention enters into force on 25 April 1980.

Attached is a note of the details, together with an outline of the views which have been communicated by Her Majesty's Government to the US Administration at the time of ratification.

The Double Taxation Convention between the UK and the US which was signed in London on 31 December 1975, and the three supplementary Protocols which were signed in London on

26 August 1976, 31 March 1977 and 15 March 1979 respectively were ratified by the Exchange of Instruments in Washington on 25 March 1980.

The Convention, as amended by the Protocols, will enter into force on 25 April 1980.

The following views have been conveyed by Her Majesty's Government to the US Administration.

It is a matter of regret to Her Majesty's Government that difficulties over one aspect of the Convention, although it is an important one, should have tended to obscure the achievement of the two Governments in reaching a fair and balanced agreement.

Among double taxation treaties, that between the British and United States Governments has a pre-eminent position. The economic and financial links between the two nations are so strong and the areas covered so diverse that, apart from its intrinsic importance to the United Kingdom and the United States of America, the Convention attracts wide interest internationally and is a source of authority in its field.

Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9 (4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its original form would have prevented the United States Government and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States.(*sic*) It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.

Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory. The Organisation for Economic Co-operation and Development has explored, encouraged and developed the "arm's-length" principle for regulating the taxation of multinational enterprises operating through subsidiary companies or branches. This principle requires that the subsidiary or branch should be taxed only by reference to the profits which its own activities generate. Where these activities involve transactions with related enterprises and these transactions are not on the basis which would be made between wholly independent enterprises, the profits are to be adjusted for tax purposes by reference to the independent enterprise test, i.e., the "arm's-length" basis. This is intended to achieve a fair measure of the profit by cancelling the effect of any artificial pricing between related enterprises. The "arm's-length" approach has been internationally accepted and is a vital feature of double taxation conventions throughout the world.

The unitary basis with combined reporting is a quite different approach. It makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the world-wide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. The problems associated with this technique are many and have been well rehearsed. The tax consequences are unpredictable and arbitrary. The widely varying commercial and economic climates in different countries produce inequitable results. Under this system it can lead to a demand for tax by reference to group profits earned from unconnected activities in other parts of the world where they are already taxed, even although (*sic*) the local subsidiary is incurring substantial losses. On the unitary basis there is likely to be unrelieved and unrelievable double taxation. In addition the compliance costs are unacceptably high.

Apart from these inherent problems associated with the unitary tax basis, its incompatibility with the internationally accepted "arm's-length" basis would generate conflicts between the international investing and trading nations and disruption of international business if the precedent implicit in the Convention were to be followed by other countries. Unless common rules for determining the allocation of profits between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment, for which the United States and the United Kingdom have striven together with their fellow members of the Organization for Economic Co-operation and Development. It is the view of Her Majesty's Government that the unitary basis, which is not a practical international alternative to the "arm's-length" basis, could undo the important and patient international work that has been achieved in regulating international tax practices, and that every effort is required to discourage the use of the extension of that basis. It is to this end that the British and United States Governments have expressly prohibited its use for the purpose of the respective national tax systems under Article 9(4); and the issue will be an important aspect of the proposed annual review of the Convention.

Her Majesty's Government has recognized, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention, the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognized the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government for the reasons given above that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.

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European Economic Community

Ambasciata D'Italia,
Washington, D.C., March 19, 1980

To the Department of State, Washington, D.C.:

The Italian Embassy presents its compliments to the Department of State and, on behalf of the Nine ECC Governments, of which the Italian Government has now the presidency, it has the honor to forward the attached Note on the problems of the unitary method of taxation.

The Italian Embassy welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

[SEAL]

Paola Pansa Cedronio,
Ambassador of Italy

1. Our Governments are concerned about the application to US subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other States.

2. The unitary basis makes no attempt to examine the profits generated by the subsidiary. It looks to the total profits of the worldwide operations of the group of which the subsidiary is a part, and claims a portion of those profits on the basis of the assumption that certain specified factors, such as the fixed asset values, turnover and payroll, affect the profits of the subsidiary in the same way and to the same extent as the profits of the group as a whole, irrespective of where the corporations of the group operate. This means that, whenever the groups as

a whole makes a profit the subsidiary will be taxed on a portion of this profit, even if the subsidiary is actually making a loss, or in the reverse situation, that the subsidiary may not be taxed if the group as a whole has made a loss, although the subsidiary is actually in a profit making position.

3. This method is incompatible with the principles accepted by all OECD member states and recommended to all states as a basis for the taxation of subsidiaries or permanent establishments of foreign enterprises. These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at "arm's length" between the subsidiary and related enterprises, i.e. that the transactions between the subsidiary and related corporations are on the same or on a comparable basis as transactions between wholly independent parties. This is intended to arrive at a fair measure of profit and rule out artificial pricing between members of the group for the sole purpose of minimizing tax liability.

4. Unless the same basic rules for calculating taxable profits are followed generally by the main trading nations it will be impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment.

5. The unitary tax basis can give rise to obviously inequable tax liabilities, and to a form of double taxation which often cannot be relieved, or can be relieved only if countries, which follow generally accepted practices, bear an unfair burden of relief.

6. Unitary taxation, because it requires worldwide reporting of the group's activities in the state where the subsidiary operates imposes very heavy compliance costs, in addition to the costs of compliance and reporting for non-US corporations in their "home countries."

7. The Federal Government uses the arms-length basis for its taxation of subsidiaries of foreign corporations.

8. The problem was addressed in the US/UK Double Taxation Treaty, Article 9(4) of the Treaty, which if supported by the Administration, would have disallowed the imposition of unitary taxes on subsidiaries of UK companies. When the Senate voted on the Treaty in 1978 the majority approved the Treaty with Article 9(4) in its original form, although the necessary two-thirds majority was not achieved. Subsequently, the Senate approved the Treaty with the necessary two-thirds majority, but subject to the reservation that Article 9(4) was not to apply for the purpose of state taxation. Article 9(4) remained in the Treaty, but only for the purpose of national taxation.

9. There are currently four relevant bills in Congress, S 983, S 1688, HR 5093 and HR 5076, the last of which is scheduled for hearings on the 31st of March.

In the view of the strong arguments against unitary taxation, our Governments urge you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment.

Extracts from Staff Report of Advisory Commission on Intergovernmental Relations Dated 9/4/81.

[Footnotes Omitted]

Among the major impediments to freer capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries. Tax treaties seek to eliminate, or at least mitigate the impact of, these impediments. [p. 5.]

Tax treaties represent a highly developed area of international cooperation. Few fields come to mind in which international groups have worked so consistently for so long. [p. 6.]

The stakes in tax harmonization, or coordination of the tax systems of various countries, involve more than a desire for orderliness in international tax matters. Without such harmonization, double taxation of income could easily occur, resulting in a loss of international investment and income flows. [p. 6.]

Specifically, tax harmonization cannot occur without an *internationally accepted set of standards* which serve as the foundation for all tax treaty negotiations. [Emphasis in original.]

Two important sets of rules for this purpose are: (1) those defining a *permanent establishment* in the host country, since the host country can only tax business profits attributable to such a permanent establishment, and (2) those specifying procedures for accounting for transactions between related parties in measuring the income of the permanent establishment. Under these latter rules, the permanent establishment, such as a branch or subsidiary corporation, is to be regarded as a *separate entity* and transactions between related parties are calculated on an *arm's length basis;* that is, as if the related parties were dealing with each other as independent enterprises at arm's length. [Emphasis in original.]

These standards have evolved from about 50 years of effort on the part of both technical experts and negotiators of tax treaties. In 1932, the first tax convention to which the U.S. was a party, that is a tax convention with France, adopted the arm's length concept. In 1934, through work supported by the League of Nations, the first model tax treaty was developed incorporating the arm's length standard. The model income tax treaty of the Organization for Economic Cooperation and Development (OECD) most recently revised in 1977, similarly embraces this arm's length concept as does the United States' model tax treaty also most recently issued by the Treasury Department in 1977.

Thus, the standard reflected in both OECD and United States model income tax treaties is a "water's edge" rule. Permanent establishments in foreign countries are considered separate entities. Even if transactions occur between related foreign and domestic corporations, the income attributable to the foreign entity is calculated by reference to transactions between independent parties.

These water's edge rules are in sharp contrast to the procedures used by some states in this country, especially California, in applying a unitary apportionment approach to worldwide combinations of affiliated firms. [pp. 8, 9, 10.]

The conflict between state use of worldwide combination and apportionment and the water's edge rules used by the federal government and in international practice can have serious implications. First, it can interfere with national objectives in tax harmonization. Charles M. Walker, former Assistant Secretary of the Treasury for Tax Policy under the Ford Administration, clearly articulated this point in testimony before the Senate Foreign Relations Committee on the then pending U.K. Treaty.

> "The important point to grasp is that the national interest is definitely harmed by the application of a state's unitary system to foreign operations. This is because that system

disrupts implementation of the nation's policy of harmonizing, through our network of bilateral tax treaties, our country's tax system with the tax systems of our treaty partners."

Second, this conflict between federal and state rules can represent a substantial irritant in international tax and trade policy. A number of foreign governments have transmitted to the United States their formal objections to use by the states of worldwide combination in the case of corporations owned by citizens in their countries. Belgium, Canada, France, Italy, the United Kingdom, and the nine governments of the European Economic Community (EEC), among others, have voiced such objections. Examples of their statements are reproduced in Appendix A [and in the Appendix of this Brief]. [pp. 10, 11, 12.]

One possible response by foreign governments on behalf of their taxpayers who find themselves in such circumstances could be some form of retaliation against the United States. . . . [S]everal countries consider the unitary approach as applied to worldwide combinations to result in the imposition of inequitable tax burdens by states on foreign-owned corporations and could involve state taxation of out-of-state, or extraterritorial, values. These countries could, therefore, conclude that some appropriate response is required to demonstrate their concern. U.S. corporations with subsidiaries located abroad would be the most likely targets.

Any U.S. owned firm could be the object of retaliation but particularly vulnerable to the use of worldwide combination by other countries would be firms incurring losses from foreign operations and those involved in selling abroad products manufactured in this country. In the end, of course, all countries would lose from the use of retaliation rather than negotiation as a means of settling international tax disagreements.

Ironically, the United States has already established a precedent here. In 1934, in response to extraterritorial taxation by France of U.S. corporations, the Congress enacted a provision of tax law that permitted the President of the United States, upon a finding that a foreign country has subjected U.S. citizens or corporations to discriminatory or extra-territorial taxes, to levy taxes on the citizens or corporations of that country at twice the normal rate. While the dispute with France was settled by treaty, the provision has remained part of current tax law (Section 891). [pp. 16, 17.]

Extracts from Report of OECD Committee on Fiscal Affairs, "Transfer Pricing in Multinational Enterprises" (1979)

[Footnotes Omitted]

It is generally acknowledged that, in taxing the profits of an enterprise which engages in transactions with associated enterprises outside the jurisdiction of the relevant taxing authority, the profits should be calculated on the assumption that the prices charged in these transactions are arm's length prices. This is the underlying assumption in Article 9(1) of the OECD Model Double Taxation Convention on Income and Capital (1977) on transactions between associated enterprises. In this context, it may be noted that the arm's length approach, which underlies this report, has also been endorsed by the United Nations Group of Experts on Tax Treaties between Developed and Developing Countries, and that there is a broad consensus among governments of developed and developing countries and MNEs [multinational enterprises] that arm's length pricing is the appropriate approach to adopt in arriving at profits for tax purposes. Modern bilateral double taxation conventions between OECD Member States and between OECD members and other States have accordingly adopted this principle. [pp. 8, 9]

Proposals for radical reformulations of the approach to intragroup transfer pricing which would move away from the arm's length approach towards so-called global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates, are not endorsed in this report. The use of such alternatives to the arm's length principle is incompatible in fact with Articles 7 and 9 of the OECD Model Double Taxation Convention. Such methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources, thus producing an allocation of profits which may bear no sound

relationship to the economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses (or possibly the contrary). A number of such methods are sometimes advocated, allocating profits in some cases in proportion to the respective costs of the associated enterprises, sometimes in proportion to their respective turnovers or to their respective labour forces, or by some formula taking account of several such criteria. They are all however to some degree arbitrary. For example, it does not follow that profit is uniformly related to cost at all stages in an integrated production and marketing process. Indeed the problem of allocating costs could well be no easier than in using the cost plus method to arrive at an arm's length price. Nor does it follow that labour costs are the same for the same labour in different countries, or that profits are necessarily related to any simple combination of such factors. To allocate profits by such methods in a way which reduced the arbitrariness of the results to a negligible degree would necessitate a complex analysis of the different functions of the various associated enterprises and a sophisticated weighing up of the different risks and profit opportunities in the various different stages of manufacturing, transportation, marketing and so on. Nor would the information necessary for such an assessment be readily available or, in many cases, available at all. The need would be for full information about the total activities of the whole MNE [multinational enterprise]. While the widest range of such information may be available to the tax authorities in the country of the parent company in a group even those tax authorities will be limited to some extent in the information which they can compile. The tax authorities of the country in which a subsidiary is situated will on the other hand be in no position to acquire even this amount of information without imposing on the MNE itself a possibly intolerable administrative burden, or a similar burden on the tax authorities of the parent company's country if they seek to get the information by way of exchange of information provisions under double

taxation agreements. Nor can it be generally assumed that the tax authorities of the country of the subsidiary should in any case be entitled to quite such a wide range of information about the group's worldwide activities. In practice moreover the information may simply not be available to those authorities. Even if the information were available, however, the varied activities of any MNE and the varied circumstances and situations in which they are carried on must make it impracticable for the tax authorities of the country in which one subsidiary is situated to judge in any satisfactory manner the profitability of any of the other parts of the group situated elsewhere. Moreover, problems would still arise in the comparison of figures produced in different countries by different accounting methods and different legal requirements. Another major disadvantage of any attempt to use such global methods of profit allocation as an alternative to the arm's length principle is that their unco-ordinated use by the tax authorities of several countries would involve the danger that, overall, the MNE affected would suffer double taxation of its profits. [pp. 14, 15.]

Extracts from Seventh Report, Report of the Group of Experts on Tax Treaties Between Developed and Developing Countries on the Work of Its Seventh Meeting, United Nations, Department of Economic and Social Affairs, "Tax Treaties Between Developed and Developing Countries" (1978)

[Footnotes Omitted]

The Group of Experts was reminded that the 1974 Group of Eminent Persons Appointed to Study the Impact of Multinational Corporations on Development and on International Relations had in its May 1974 report to the Secretary-General expressed the following views:

> "We note with satisfaction that transfer pricing has been engaging the attention of the United Nations Group of Experts on Tax Treaties, the International Fiscal Association, the Organisation [sic] for Economic Co-operation and Development and the Commission of the European Communities. We trust that, as a result of their efforts, it will be possible for the international community to agree upon a code which home and host countries alike will find practicable and advantageous to enforce. . . . The general principle is to refer to 'arm's length' prices, that is, prices as they are or would be charged by an independent seller to an independent buyer.

The view was expressed that it should be stressed that the Group of Experts had unanimously recognized the validity of the arm's length principle and that Governments should apply arm's length pricing wherever appropriate. [p. 62.]

Extracts from "Business Week" dated 11/2/81.

Recent Japanese reaction to California's tax policy has been outspoken. For example, Yoshihiro Inayama, President of Japan's Federation of Economic Organizations, has written to Treasury Secretary Donald T. Regan warning that the unitary tax is holding up investments in California. And in San Francisco, Shinji Mizuchi, Senior Vice-President of Japanese-owned California First Bank, notes that Nippon Electric Corp. (NEC) recently bought land for a plant outside Sacramento, but postponed building it because of the state unitary tax. "Companies like Sony would have expanded more in California [if not for the tax]," Mizuchi adds.

In a typical reaction in Britain, Don Haywood, head of taxation for BAT Industries Ltd., whose U.S. subsidiary, Batus Inc., showed a 1980 profit of nearly $200 million, complains that his firm had "never accepted" that California had the right to tax on the unitary plan. "We have warehouses there, but I don't think we would dream of putting manufacturing facilities there," he says. Haywood notes that Batus, which owns Gimbel Bros. Inc. and Saks Fifth Avenue department stores in the U.S., recently built a papermaking plant outside of California, partly to avoid that state's taxation.

A German protest. Similar complaints come from Germany. "It would be disastrous if it [California's taxing formula] were applied in other countries," says Hans Flick, finance and tax chief of the German Chamber of Commerce & Industry. He is particularly concerned about the implications for German companies doing business in Third World nations, where the companies often endure years of losses to gain a position in the market. Such companies would "be in a permanent fight" with those countries if they followed California's example and taxed on the basis of worldwide results, Flick adds. [p. 132.]

A self-defeating tax

With money-hungry states looking for any and all ways to dredge up new revenues, it is not surprising that California and several other states are trying to slap taxes on the worldwide profits of foreign multinationals that do business within their jurisdictions [page 131]. California is being challenged in court, but whatever the final decision, trying to impose state taxes on global operations is a bad idea. If the courts do not act to squelch it, Congress should.

Last year the Supreme Court ruled that if states used a reasonable formula they could tax the global earnings of U.S. multinational corporations. Now California is leading the way in trying to give the same treatment to foreign multinationals doing business within the state.

This effort is misguided on several counts. First, it is unfair to broad-based companies that may earn very little, or may even be losing money, in a given state. More important, it sets an unwelcome precedent for other states and, even worse, for foreign countries, all of which might start trying to cut themselves in on a slice of the worldwide earnings of whatever companies happened to be operating within their borders. In Third World countries particularly, corporations typically sustain years of losses on their investments before showing any earnings. This leads to another objection: Many corporations would curtail or severely limit their investments in states and countries that tried to use them for a free ride. This is already happening in California. The lesson for it and other states is that a quick-fix search for new revenues today may have to be paid for in lost growth tomorrow. [p. 156.]

RESOLUTION
OF THE COUNCIL ON UNITARY TAXATION

We, the members of the Council on Unitary Taxation Issues[1] of Kansai Area, Japan, have met on this 10th day of December, 1981, and agreed that:

BACKGROUND OF THE UNITARY TAX PROBLEM

The so-called "Unitary Tax" (i.e., combined reporting with formula apportionment) levied on worldwide income by State Authorities of the United States, including the State of California, disregards existing national boundaries and different economic conditions and practices between Japan and the United States. Furthermore, such a method of taxation presumes unrealistically that a Japanese parent company and its subsidiary in the U.S. and other countries operate on the same profit level, in spite of different nationalities and business

[1] The Council on Unitary Taxation Issues of Kansai Area, Japan is comprised of 49 companies, all located in the Kansai area of Japan, who have formed an organization to consider and react to the imposition of California's Unitary Tax to their affiliated companies. The members of the Council are: Dainippon Screen Mfg. Co., Ltd.; The Daiwa Bank Ltd.; Daiwa House Industry Co., Ltd.; Electronic Industries Association of Japan; Hanwa Co., Ltd.; The Green Cross Corporation; Horiba, Ltd.; Iwatani Co., Ltd.; Kawasaki Heavy Industries, Ltd.; Kubota, Ltd.; Kyoto Ceramic Co., Ltd.; Kyoto Chamber of Commerce and Industry; Matsushita Electric Industrial Co., Ltd.; Minolta Camera Co., Ltd.; Murata Manufacturing Company, Ltd.; Nippon Life Insurance Company; Nippon Sheet Glass Co., Ltd.; Nissin Electric Co., Ltd.; Nissin Food Products Co., Ltd.; Omron Tateishi Electronics Company; Rohm Co., Ltd.; Santory; Sanwa Bank, Ltd.; Sanyo Electric Co., Ltd.; Sharp Corporation; Shimazu Corporation; Shimpo Industrial Co., Ltd.; The Sumitomo Bank Ltd.; Sumitomo Metal Industries, Ltd.; Taiyo Co., Ltd.; Takashimaya Company, Ltd.; Takeda Chemical Industries, Ltd.; Takenaka Komuten Co., Ltd.; Tanabe Seiyaku Co., Ltd.; The Tokai Bank Ltd.; Yanmar Diesel Engine Co., Ltd.; Wacoal Corp.

practices. Application of the Unitary Tax to Japanese parent companies is creating substantial distortion problems, unreasonable administrative burdens and significant misallocation of income.

SPECIFIC PROBLEMS WITH THE WORLDWIDE APPLICATION OF THE UNITARY TAX

We have discussed and identified the following problems resulting from application of Unitary Tax on a worldwide basis:

1. By expanding its tax jurisdiction beyond state boundaries to Japan and other foreign countries, some States, including the State of California, which employ the Unitary Taxation method on a worldwide basis cause double taxation of income earned by Japanese parent corporations.

2. Without any reasonable grounds, States, including the State of California, which employ the Unitary Taxation method on a worldwide basis levy irrational taxes on income significantly different from that which Japanese subsidiaries in the States actually earned.

3. Japanese companies which have made direct and substantial investments in the U.S. to establish subsidiaries are burdened unnecessarily and excessively, in comparison with U.S. domestic companies, by the state imposed requirement of gathering, maintaining and supplying additional accounting data.

4. Application of the Unitary Tax on a worldwide basis poses a serious impediment to further Japanese investment in the United States, despite the fact that the United States is making a serious effort to promote such Japanese investment in the U.S.

RESOLUTION AND CONCERNS

Based on the problems listed above, we have agreed to oppose, in the most decisive manner, application of the Unitary Tax on a worldwide basis.

In addition, we are deeply concerned with the recent trend in the United States of additional states in the U.S. taking steps to apply the Unitary Taxation method on a worldwide basis to foreign companies.

Furthermore, we are concerned that nations of the developing countries may also begin to apply the Unitary Tax to foreign parent corporations. If the Unitary Taxation method prevails to such an extent, internationally accepted taxation principles will be disordered and, as a result, international trade and investment would be damaged.

RECOMMENDATIONS TO THE GOVERNMENTS OF JAPAN AND THE U.S.

With this resolution, we strongly urge the governments of Japan and the United States to take the following action:

1. Both governments should exert strong initiatives to lead all the states of the United States to adopt the so-called arm's-length principle for apportioning the taxable income of Japanese parent corporations and their U.S. subsidiaries. We believe that, as the U.S.-Japan tax treaty and the U.S. Federal tax law provide, the arm's-length standard is a fair and reasonable taxation method with respect to business transactions between Japan and the United States.

2. Both governments should take notice of the substantial impact which the Unitary Tax is having on bilateral trade and investment activities. The Japanese government should explicitly notify the U.S. government that, unless the unfairness imposed by the Unitary Tax is resolved, the Japanese government shall be concerned with a critical disruption of the bilateral investment relationship.

3. In close co-operation with Western European countries, which also object to the unfairness of the Unitary Tax (applied on a worldwide basis), the Japanese government should consider raising the issue for discussion at a meeting of GATT.

CONCLUDING RECOMMENDATION TO JAPANESE BUSINESSES

Because of our grave concern with the inequitable nature of Unitary Taxation on our foreign investment activities, we, the members of the Committee on Unitary Taxation Issues in the Kansai area, earnestly appeal to the Japanese corporate decision makers to reconsider their foreign investment policies, and make no further direct investment in the States of the United States which impose or are imposing a Unitary Tax on a worldwide basis.